Report To The Congress

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Commodity Futures Regulation--Current Status And Unresolved Problems

GAO recommends that the Congress reauthorize Federal commodity regulatory programs this year. Since 1978, when the Commission was last reauthorized, it has made progress in developing a regulatory framework to protect commodity customers.

The Commission's principal programs--including registration of commodities professionals, contract approval and market surveillance, review of commodity exchanges' efforts to enforce their own rules, and a reparations system--can be improved. GAO makes specific recommendations for upgrading these programs.

Despite their need for improvement, these programs must be reauthorized if rapidly expanding futures trading is to operate reasonably free from abuse. Even if the exchanges can assume an increasing share of the responsibility for regulating their own activities--an important Commission objective--there will be a continued need for Federal monitoring of industry self-regulatory programs.

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COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

COMMODITY FUTURES REGULATION--CURRENT STATUS AND UNRESOLVED PROBLEMS

D I G E S T

Trading in futures contracts on the Nation's 11 commodity exchanges has grown dramatically during the last decade. For example, in 1970 over 13 million contracts valued at $148 million were traded on the Nation's commodity exchanges compared with 101 million contracts valued in the trillions being traded in 1981. Also, the concept of a commodity has expanded to include financial instruments, such as Treasury bills and bonds and stock indexes, in addition to traditional commodities, such as wheat and soybeans. This growth and expansion has increased the importance of futures trading in the Nation's economy.

To oversee commodity futures trading, the Congress, in 1974, created the Commodity Futures Trading Commission. The Commission's current authorization expires in 1982. GAO undertook this review of the Commission's activities to help the Congress evaluate the Commission's performance and consider changes to the Commission's enabling legislation. GAO's findings regarding needed improvements in Commission programs are based on an assessment of whether the Commission's programs meet the objectives established by the Congress and measure up to the Commission's own stated objectives.

FEDERAL COMMODITY REGULATION IS ESSENTIAL

GAO recommends that the Congress reauthorize Federal commodity regulatory programs in 1982. Since 1978, when the Commission was last reauthorized, it has made progress in developing a regulatory framework to protect commodities customers. The principal Federal programs for commodity futures regulation--including registration, market surveillance, and review of commodity exchanges' rule enforcement--must continue if futures trading is to operate reasonably free from abuse. Even if exchanges

assume increasing responsibility for key aspects of regulating futures trading--an important Commission objective--the Federal Government must continue to monitor exchange performance to determine whether self-regulation is working acceptably. (See p. 9.)

INDUSTRY SELF-REGULATION

The Commodity Exchange Act requires exchanges to establish and enforce rules to govern futures trading. One of the Commission's most important programs is reviewing exchanges' rule enforcement procedures and performance. The Commission's reviews have not covered all aspects of exchange programs often enough and have not promptly followed up on previously identified deficiencies. Consequently, the rule enforcement review program has not brought about needed improvements in exchange self-regulation. GAO recommends that the Commission (1) improve the criteria it uses to assess exchange rule enforcement programs, (2) conduct more frequent reviews, and (3) link approval of trading in a new futures contract at an exchange with exchange adherence to the act's and the Commission's self-regulatory requirements. (See p. 134.)

ECONOMIC FUNCTION OF FUTURES MARKETS

Futures markets help establish cash prices or provide an opportunity to hedge the risk of commodity ownership. The Commission reviews and approves futures contracts before they are traded to ensure that they will serve these functions. After trading begins, the Commission and the exchanges maintain market surveillance programs to detect market manipulation and other harmful activity.

Since GAO's 1978 review, the Commission has improved its assessment of proposed futures contracts. For example, it now more thoroughly analyzes information submitted to support contract approval; however, the Commission still needs to strengthen and clarify its approval requirements.

The Commission has focused much effort on approving new contracts at the expense of reviewing contracts that are already being

traded. GAO believes the Commission should devote more effort to existing contracts to determine that they are actually meeting their economic function. GAO recommends that the Commission offset the expenses of contract review and approval by charging exchanges a user fee when they submit contracts for approval. (See p. 33.)

In conducting its market surveillance program, the Commission collects, analyzes, and compares, on a daily basis, data on supply and demand conditions in the cash and futures markets, and, in particular, on the size and dominance of traders' market positions. Weaknesses in its overall automatic data processing programs prevent the Commission from collecting and analyzing this data in a way that can effectively support its surveillance program. GAO, therefore, recommends improvements in the Commission's collection and processing systems. (See p. 55.)

In addition, the Commission needs to ensure that exchanges have sufficient data to carry out their share of market surveillance. GAO recommends that the Congress amend section 8a(6) of the Commodity Exchange Act to allow the Commission to share data on traders' positions with the exchanges. (See p. 56.)

PROTECTION OF FUTURES CUSTOMERS

The Commission maintains three major customer protection programs--registration of commodity professionals, auditing and financial surveillance of firms dealing in commodities, and reparations. The Commission's efforts to register industry professionals and to identify and remove unfit individuals can be improved. For example, although the Commission has required commodity trading advisors and commodity pool operators to register, the salespersons and supervisors who actually solicit business for these firms are not presently required to do so. (See p. 68.)

The Commission can take additional actions to assure registrants' fitness by requiring futures commission merchants to (1) sponsor and review the registration application of persons associated with their firms and (2) fingerprint registrants and submit their fingerprints

to the Federal Bureau of Investigation for review. (See p. 63.)

The newly created National Futures Association is expected to assume many of the Commission's registration responsibilities. The Commission, however, needs to more actively plan for the transfer of registration functions to the Association. To overcome existing limitations on the Association's registration authority and allow a more complete transfer of responsibility, GAO recommends that the Congress amend the Commodity Exchange Act to authorize the Association to assume registration functions now performed by the Commission. (See p. 74.)

AUDIT AND FINANCIAL SURVEILLANCE

The Commission tries to deter financial failures and detect improper financial practices that could lead to loss of customer funds. The Commission shares this responsibility with the commodity exchanges, which establish and enforce minimum financial requirements for their members. The Commission monitors exchange audit and financial surveillance programs. (See p. 76.)

GAO recommends that the Commission place more reliance on surveillance by the exchanges and the National Futures Association when it begins operating. In doing so, however, the Commission will need to improve its program for monitoring exchange audit and financial surveillance activities. GAO believes this shifting of focus will allow the Commission to devote more audit resources to other areas for which it is primarily responsible. (See p. 77.)

FORUMS FOR ADDRESSING CUSTOMER CLAIMS

In 1974 the Congress amended the Commodity Exchange Act to establish a reparations program as a forum for resolving disputes between commodity customers and industry professionals. The reparations program is not meeting its objectives: statistics indicate that a complaint takes an average of 3 years to complete the entire reparations process; complainants

have difficulty understanding the program; and reparations is expensive--commodity attorneys charge fees ranging from $1,500 to $10,000. (See p. 182.)

To improve the reparations program, GAO recommends that the Commission (1) improve its collection of information essential to program management, (2) make the program's operation clearer to participants, and (3) develop arbitration as a more effective alternative to reparations. (See p. 194.) To increase the potential for use of arbitration, GAO recommends that the Congress raise from $15,000 to $25,000 the dollar limit for claims that customers can compel exchange members to arbitrate. (See p. 195.)

AUTOMATIC DATA PROCESSING

The Commission must collect and analyze large amounts of data to accomplish its regulatory functions. The Commission's information resources, however, have become outdated and do not adequately support its programs. GAO recommends that the Commission establish a process that gives direction to the automatic data processing program and develop agency-wide standards to plan and control software development. These steps will serve to update and improve the Commission's management of its information resources. (See p. 215.)

AGENCY AND OTHER COMMENTS AND GAO's EVALUATION

In March 1982 GAO provided a draft version of this report to the Commission, to other interested Federal agencies, and to affected commodities exchanges. The Commission expressed concern that the report did not recognize the agency's progress in strengthening its management since GAO's 1978 review. The Commission also stated that it had adopted or was in the process of adopting more than 30 specific actions recommended by GAO. GAO has revised the report to reflect these recent actions more fully.

In comments pertaining to individual chapters of the report, the Commission made suggestions for updating, clarifying, and in some cases correcting GAO's statements. The Commission's

comments were most numerous and detailed concerning two chapters dealing with its audit and financial surveillance and rule enforcement review programs which it believed contained inaccuracies. (See chs. 6 and 7.) GAO has addressed all of the Commission's comments at the conclusion of the chapters to which they pertain. GAO has modified the report where appropriate in response to these comments. GAO accorded similar treatment to the comments of various commodity exchanges, the National Futures Association, and the Department of Justice. (See apps. XV and XVI, respectively, for the complete text of agency comments and comments from exchanges and other parties.)

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ABBREVIATIONS

ADP	Automatic data processing
AICPA	American Institute of Certified Public Accountants
ALJ	Administrative Law Judge
AP	Associated Person
CFTC	Commodity Futures Trading Commission
CPO	Commodity Pool Operator
CTA	Commodity Trading Advisor
FB	Floor Broker
FBI	Federal Bureau of Investigation
FCM	Futures Commission Merchant
GAO	General Accounting Office
NFA	National Futures Association
OMB	Office of Management and Budget
SEC	Securities and Exchange Commission